THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA

INFORMATION

- **Board of Directors**
  Business and Finance Committee

3/9/2010 Board Meeting

9-1

Subject

Options for 2010/11 rates and charges

Description

SUMMARY

In April 2009, the Board considered whether to adopt rates and charges for 2009/10 that would cover Metropolitan's full cost of service, or to adopt lower rates and charges and utilize reserve funds to cover the balance of Metropolitan's costs. After considerable debate and study, and in consideration of the difficult economic climate in the region, the Board determined to adopt a lower rate, draw upon financial reserves and expressed intent to raise rates in fiscal year 2010/11 to cover the full cost of service. The Board also undertook a thorough review of Metropolitan's budget and directed a series of cuts in service to mitigate the impacts of rate hikes. Finally, the Board directed staff to work with the member agencies on a comprehensive review of Metropolitan's cost of service methodology.

Staff has been working with the member agencies on the cost of service review and there have been a series of workshops and meetings over the past 9 months. Final recommendations from the process will be brought to the Board as part of the long-term financial plan process at the end of 2010. Staff did bring suggested interim changes to the cost of service methodology for consideration at the November 2009 Business and Finance Committee meeting and the Committee determined to not take interim actions until the final review is complete and all recommendations could be analyzed together.

Staff began a detailed review of the proposed 2010/11 budget and rates with the Board in January. This review process has included monthly discussion at the Business and Finance Committee, two Board workshops and monthly discussions with the member agency managers. These discussions have focused on the need to balance difficult external economic conditions impacting the member agencies and the importance of maintaining Metropolitan's financial health. Much of the discussion has been centered on the value of Metropolitan's high bond ratings and the need to preserve those excellent ratings which ultimately provide considerable savings to rate payers.

This board letter brings forward three options for the Board to discuss and provide input. A formal staff recommendation will be presented at the April meeting. Options 1 and 3 are calculated to recover the full cost of service in fiscal year 2010/11, consistent with the Board's direction last year. Option 2 incorporates feedback from discussions over the past months from some agencies that would prefer to spread the impact of full cost of service over two years.

The three options are as follows:

- Option 1 – Average rate increase of 12.4 percent on January 1, 2011. Option 1 would recover Metropolitan's full cost of service in 2010/11 without draws from financial reserves.
- Option 2 – Average rate increases of 7.5 percent on January 1, 2011 and 7.5 percent on January 1, 2012. Option 2 would require draws of about $19 million from reserves in 2010/11. Revenues would recover the full cost of service in 2011/12.

- Option 3 – Average rate increase of 9.6 percent on January 1, 2011 and no change to Metropolitan's property tax rate. Under this option the Board would authorize staff to seek a legislative change to the MWD Act, fixing the property tax rate at current levels (0.0043 percent of assessed valuations in Metropolitan's service area). This would generate approximately $10 million in additional tax revenues compared to Option 1 and Option 2. Option 3 would recover the full cost of service in 2010/11 without draws from financial reserves.

DETAILED ANALYSIS

The process to review the proposed 2010/11 budget and rates and charges with the Board has focused on many of the assumptions that affect the need to raise rates. The following are key assumptions common to each rate option presented in this letter:

- 2010/11 budget expenditures of $1.732 billion, a $66-million reduction from the 2009/10 budget.
- 2010/11 departmental O&M expenditures of about $338 million, a $3-million reduction from the 2009/10 budget.
- Pay-As-You-Go (PAYGO) funding of the Capital Investment Plan in 2010/11 of $95 million followed by $125 million in 2011/12.
- Water sales of 1.93 million acre-feet in 2010/11 and 2.0 million acre-feet in 2011/12.

Option 1 – Average rate increase of 12.4 percent in 2011: Under this option, rates and charges would increase by 12.4 percent on January 1, 2011. This option would generate an additional $48 million in revenues in 2010/11 and would recover the full cost of service without draws from financial reserves. Revenue bond debt service coverage, an important indicator of Metropolitan's financial health, would be 1.9 times in 2010/11. With an additional rate increase of about 2 percent in 2012 the revenue bond debt service coverage would be 2.1, which is slightly better than the board-adopted target of 2.0.

Figure 1. Option 1 - Rate Stabilization Reserves

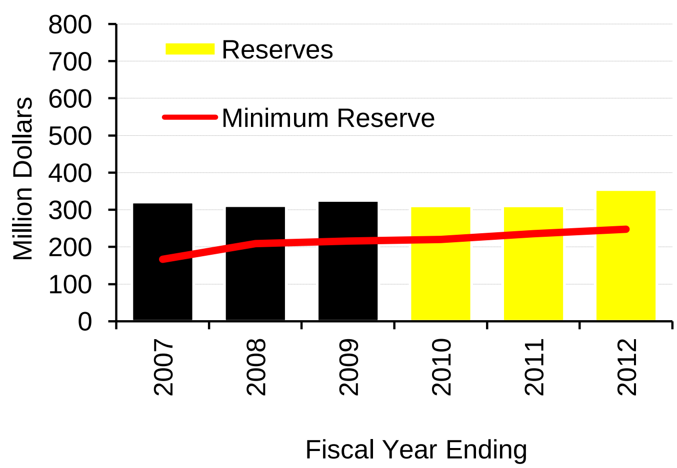


Table 1 shows the detailed breakdown of rates and charges that would result from Option 1.

Table 1. Option 1: Rates and Charges

	Effective Jan 1, 2010	Effective Jan. 1, 2011
Tier 1 Supply Rate ($/AF)	$101	$112
Delta Supply Surcharge ($/AF)	$69	$51
Tier 2 Supply Rate ($/AF)	$280	$280
System Access Rate ($/AF)	$154	$217
Water Stewardship Rate ($/AF)	$41	$43
System Power Rate ($/AF)	$119	$135
Full Service Untreated Volumetric Cost ($/AF)		
Tier 1	$484	$558
Tier 2	$594	$675
Replenishment Water Rate Untreated ($/AF)	$366	$440
Interim Agricultural Water Program Untreated ($/AF)	$416	$513
Treatment Surcharge ($/AF)	$217	$217
Full Service Treated Volumetric Cost ($/AF)		
Tier 1	$701	$775
Tier 2	$811	$892
Treated Replenishment Water Rate ($/AF)	$558	$632
Treated Interim Agricultural Water Program ($/AF)	$615	$718
Readiness-to-Serve Charge ($M)	$114	$133
Capacity Charge ($/cfs)	$7,200	$7,200

Option 2 – Average rate increases of 7.5 percent in 2011 and 7.5 percent in 2012: This option would establish rates and charges for two years through an average increase of 7.5 percent on January 1, 2011, followed by another 7.5 percent increase on January 1, 2012. This option reduces the rate impact on member agencies in 2010/11. Metropolitan would not recover the full cost of service in 2010/11 and $19 million would be drawn from reserves. However, with the second rate increase in 2011/12 Metropolitan would recover the full cost of service. This option would generate an additional $29 million in revenues in 2010/11. Revenue bond debt service coverage would be 1.9 in 2010/11 and 2.0 in 2011/12.

Option 2 is not consistent with the previous Board direction to recover the full cost of service in 2010/11. The commitment to set rates that recover the full cost of service has been an important consideration for bond rating agencies as Metropolitan's current financial metrics are below desired levels. While Option 2 recovers the full cost of service in 2011/12, it represents a somewhat riskier financial condition when compared to Option 1 and Option 3.

Figure 2. Option 2 – Rate Stabilization Reserves

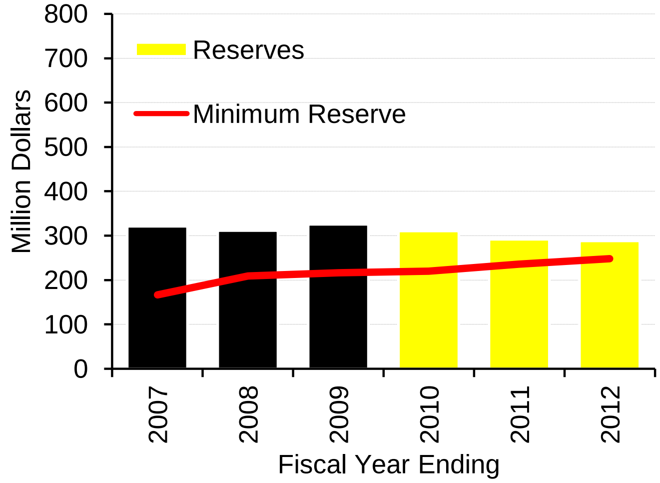


Table 2 shows the detailed breakdown of rates and charges that would result from Option 2.

Table 2. Option 2 – Rates and Charges

	Effective Jan 1, 2010	Effective Jan. 1, 2011	Effective Jan. 1, 2012
Tier 1 Supply Rate ($/AF)	$101	$104	$106
Delta Supply Surcharge ($/AF)	$69	$51	$58
Tier 2 Supply Rate ($/AF)	$280	$280	$290
System Access Rate ($/AF)	$154	$207	$217
Water Stewardship Rate ($/AF)	$41	$41	$43
System Power Rate ($/AF)	$119	$129	$136
Full Service Untreated Volumetric Cost ($/AF)			
Tier 1	$484	$532	$560
Tier 2	$594	$657	$686
Replenishment Water Rate Untreated ($/AF)	$366	$414	$442
Interim Agricultural Water Program Untreated ($/AF)	$416	$487	$537
Treatment Surcharge ($/AF)	$217	$207	$234
Full Service Treated Volumetric Cost ($/AF)			
Tier 1	$701	$739	$794
Tier 2	$811	$864	$920
Treated Replenishment Water Rate ($/AF)	$558	$596	$651
Treated Interim Agricultural Water Program ($/AF)	$615	$682	$795
Readiness-to-Serve Charge ($M)	$114	$128	$146
Capacity Charge ($/cfs)	$7,200	$7,200	$7,400

Option 3 – Average rate increase of 9.6 percent in 2011 and no change to Metropolitan's property tax rate: This option presents an average increase in rates and charges of 9.6 percent on January 1, 2011. In addition to the rate increase, Metropolitan would maintain the current property tax rate of 0.0043 percent of assessed valuations in the service area. Under Option 3 Metropolitan would sponsor legislation to change Section 124.5 of the MWD Act to allow Metropolitan to cap the maximum tax levy rate at the rate in effect for fiscal year 2009/10. At present, Metropolitan's tax rate is capped at the amount needed to recover only the cost of Metropolitan's general obligation bond annual debt service and the portion of the State Water Contract for debt service on State general obligation bonds (Burns Porter bonds) issued to finance facilities that benefit Metropolitan and outstanding in the 1990/91 fiscal year. These costs are projected to decline by about $10 million in 2010/11. Maintaining the tax rate at its current level would generate an additional $10 million in tax revenues in 2010/11 compared to Option 1 and Option 2. This would reduce the need for revenues to be generated from rates and charges, resulting in a 9.6 percent average rate increase in 2011. The 9.6 percent average rate increase would generate an additional $38 million in 2010/11, recovering the full cost of service without any draws from financial reserves. Revenue bond coverage would be 1.9 in 2010/11 and 2.0 in 2011/12.

If legislation allowing Metropolitan to maintain a flat property tax rate is not passed, then Option 3 could result in draws from reserves of as much as $10 million in 2010/11. With declining property tax revenues, Metropolitan would need to increase rates and charges by more than 2 percent in 2011/12 to recover the full cost of service.

Figure 3. Option 3 – Rate Stabilization Reserves

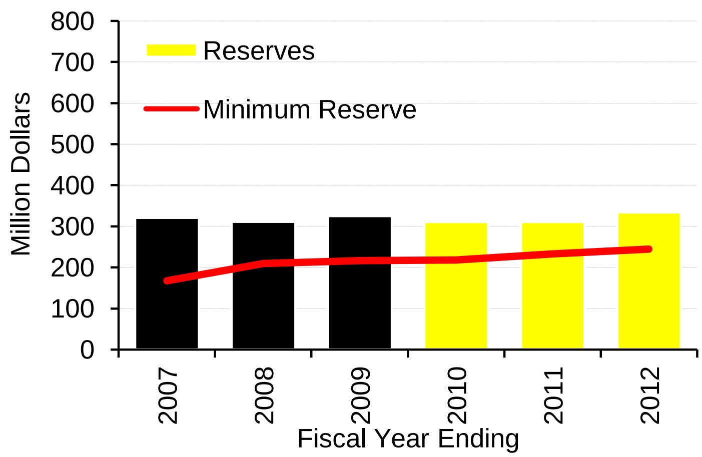


Table 3 shows the detailed breakdown of rates and charges that would result from Option 3.

Table 3. Option 3 – Rates and Charges

	Effective Jan 1, 2010	Effective Jan. 1, 2011
Tier 1 Supply Rate ($/AF)	$101	$108
Delta Supply Surcharge ($/AF)	$69	$51
Tier 2 Supply Rate ($/AF)	$280	$280
System Access Rate ($/AF)	$154	$207
Water Stewardship Rate ($/AF)	$41	$42
System Power Rate ($/AF)	$119	$133
Full Service Untreated Volumetric Cost ($/AF)		
Tier 1	$484	$541
Tier 2	$594	$662
Replenishment Water Rate Untreated ($/AF)	$366	$423
Interim Agricultural Water Program Untreated ($/AF)	$416	$496
Treatment Surcharge ($/AF)	$217	$214
Full Service Treated Volumetric Cost ($/AF)		
Tier 1	$701	$755
Tier 2	$811	$876
Treated Replenishment Water Rate ($/AF)	$558	$612
Treated Interim Agricultural Water Program ($/AF)	$615	$698
Readiness-to-Serve Charge ($M)	$114	$131
Capacity Charge ($/cfs)	$7,200	$7,200

Ad valorem tax rate

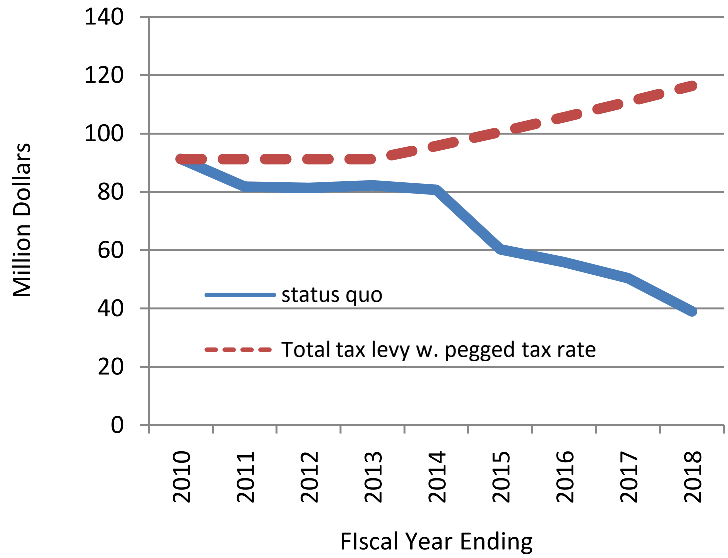
A change in the Metropolitan Water District Act is required to implement Option 3. Despite the fact that Metropolitan currently has statutory authority and voter authorization to levy ad valorem tax assessments on property within its service territory for its own general obligation bonds and its State Water Contract obligation, since fiscal year 1990/91, Section 124.5 of the MWD Act limits property tax revenues (and thereby the tax levy rate) to the total of annual debt service on Metropolitan's general obligation bonds and the portion of the State Water Contract payment for debt service on State general obligation bonds (Burns Porter bonds) issued to finance facilities that benefit Metropolitan and outstanding in the 1990/91 fiscal year. As principal payments on these bonds are made, the sum of these amounts decreases over time. This limitation was a result of a change to the Act in 1984.

Metropolitan would seek to cap its tax levy rate at the current level of 0.0043 percent to help mitigate impacts on future water rates due to increased costs of capital facilities paid through the State Water Contract. Under the State Water Contract, Metropolitan and all other contractors are authorized to use property tax revenues to make payments to California to fund their share of the State Water Project costs. As the Board is aware, significant new costs are expected to be added to the State Water Project as part of any "Delta Fix".

The majority of other State Water Contractors recover their costs of the State Water Project from ad valorem taxes. Metropolitan is unique in that it only collects that portion of cost associated with the Burns Porter Bonds through its ad valorem tax rate. Over the next 30 years, this change in legislation would enable Metropolitan to be more aligned with all other State Water Contractors, whereby a larger portion of the State Water Contract costs could be paid with property taxes. Absent this legislative change, eventually all of Metropolitan's State Water

Project costs would be paid from the water rate. No other State Water Contractor funds its obligation solely with water rates.

Figure 4: Impact of Proposed Legislation Fixing Tax Levy on AV Tax Revenues



In Figure 4, the solid line represents Metropolitan's future ad valorem tax revenues based on the current language in Section 124.5 of the MWD Act. Because Metropolitan's general obligation bond debt service and the State Water Contract payment for debt service on State general obligation bonds are decreasing over time, absent any change to Section 124.5, Metropolitan's property tax revenues will decrease. The dashed line represents the ad valorem tax revenue Metropolitan may realize assuming the ad valorem tax rate is fixed at the current level of 0.0043 percent of assessed valuation. The dashed line reflects the assumption that assessed valuations remain flat through 2013 given adverse economic conditions. Assessed valuations are assumed to increase at 5 percent annually after 2013. By 2018, the ad valorem tax revenue would be approximately $116 million, or almost $77 million higher than the status quo. This $77 million in tax revenue represents a revenue stream to help fund needed improvements in the Delta. By simply capping the tax rate, the need for future water rate increases would be reduced by approximately $37 per acre-foot by 2018.

Description of Legislation Change

Based on a review of the MWD Act, the following changes to Section 124.5 would be necessary in order for Metropolitan to implement the fixed Ad Valorem tax assessment:

> Subject only to the exception in this section and notwithstanding any other provision of law, ~~commencing with the 1990-91 fiscal year~~ any ad valorem property tax levied by a district on taxable property in the district, other than special taxes levied and collected pursuant to annexation proceedings pursuant to Articles 1 (commencing with Section 350), 2 (commencing with Section 360), 3 (commencing with Section 370), and 6 (commencing with Section 405) of Chapter 1 of Part 7, shall ~~not exceed~~ be the composite amount required to pay (1) the principal and interest on general obligation bonded indebtedness of the district and (2) that portion of the district's payment obligation under a water service contract with the state which is reasonably allocable, as determined by the district, to the payment by the state of costs ~~principal and interest on bonds issued pursuant to the California Water Resources Development Bond Act as of the effective date of this section and used to finance~~ for construction of facilities for the benefit of the district, but in no case shall such ad valorem tax rate exceed 0.0043 percent, which is the rate that was in effect during the fiscal year 2009/10. The restrictions contained in this section do not apply if the board of directors of the district, following a hearing held to consider that

issue, finds that a tax in excess of these restrictions is essential to the fiscal integrity of the district, and written notice of the hearing is filed with the offices of the Speaker of the Assembly and the President pro Tempore of the Senate at least 10 days prior to that date of the hearing. Special taxes to pay debt service on general obligation bonded indebtedness of the district approved by voters after January 1, 2010, if any, shall not be limited under this section.

Delta Supply Surcharge

Each rate option continues to include a Delta Supply Surcharge, which applies to every acre-foot sold or wheeled through Metropolitan's system. The Delta Supply Surcharge reflects the costs of the additional supply that Metropolitan needs to procure as a result of the Delta pumping restrictions, a portion of SWP costs charged to Supply, and the cost of personnel and consultants working on Delta improvements. These costs are estimated to be around $87 million in 2010/11; about $30 million lower than the projection used to set the 2010 Delta Supply Surcharge. The reduced costs reflect lower supply program expenditures, largely due to reduced Drought Water Bank purchases based on actual experience in 2009. As a result of these lower costs, the Delta Supply Surcharge would be decreased by $18 per acre-foot to $51 per acre-foot in 2011.

This is an information letter presented for background and discussion, and input from the Board, the public, and member agencies. A formal recommendation on 2010/11 rates and charges will be presented in April, pursuant to board direction.

2/25/2010

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2/25/2010

Jeffrey Kightlinger *Date*
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Ref# CFO12604584